Internal Revenue Service

memorandum

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to: Chief, Special Procedures Function, Northern California District
Attn: Jane Allen, Insolvency Advisor

from: District Counsel, Northern California District CC:WR:NCA:SF
Michael E. Melone, Attorney

subject: [redacted]
SSN: [redacted]

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This memorandum responds to your request for advice regarding the value of a secured claim in a Chapter 13 bankruptcy following the discharge of the underlying tax in a previous Chapter 7 bankruptcy proceeding.

FACTS

The debtor filed a Chapter 7 petition on [redacted] and received a discharge in [redacted]. The debtor filed a Chapter 13 petition in [redacted]. The Service filed a proof of

claim in the Chapter 13 proceeding which included liabilities for certain years for which the underlying tax liability had been discharged in the Chapter 7 proceeding. Notices of federal tax lien (NFTL) were filed as follows:

Tax Year	Date NFTL Filed
[redacted]	[redacted]

The debtor is trying to sell or refinance real property which was part of both the Chapter 7 and Chapter 13 bankruptcy estates. It is not known whether the real property was an exempt asset in the Chapter 7 proceeding.

ISSUE

Does the federal tax lien for taxes discharged in a Chapter 7 bankruptcy, which attached to real property prior to the Chapter 7 petition, attach to the appreciated value of the real property in a subsequent Chapter 13 proceeding?

SHORT ANSWER

The Ninth Circuit generally holds that a pre-bankruptcy tax lien does not attach to assets acquired after bankruptcy. The issue in this case would be one of first impression in the Ninth Circuit. The Service could assert fair market value as the value of its in rem lien rights, but should be prepared to adjust that valuation based on possible hazards of litigation.

LAW AND ANALYSIS

Overview of Law

The courts are divided regarding whether the Service's lien attaches to post-petition property. Several courts, including the Ninth Circuit Court of Appeals, have held that the automatic stay prevents a pre-petition tax lien from attaching to post-petition assets. E.g., In re Fuller, 134 B.R. 945 (9th Cir. BAP 1992); In re Parr Meadows Racing Ass'n Inc., 880 F.2d 1540 (2d Cir. 1989); In re Larsen, 93-2 U.S.T.C. ¶ 50,508 (Bankr. N.D. 1993). These courts rely on B.C. §§ 362(a)(4) and (5), which prohibit any act to create, perfect, or enforce a lien against (1) property of the estate and (2) property of the debtor to the extent such lien secures a pre-petition debt. The courts generally reason that

since the automatic stay prevents the taxing authority from creating or perfecting a lien on a post-petition asset, the lien never attaches to such asset.

Other courts have ruled that the separate estate concept embodied by section 541 precludes the tax lien from attaching to post-petition property. Generally, section 541 creates a separate estate upon the filing of the petition which consists of pre-petition property, property acquired by the estate, and proceeds, offspring, rents, and profits of estate property with the exception of service based earnings of individuals and other limited exceptions. The cases reason that (1) there is no express bankruptcy provision allowing tax liens to attach to property acquired by the estate post-petition and (2) the tax lien does not attach to property held by this separate entity as the taxpayer lacks a right to such property. See, e.g., In re Fuller supra at 948; In re Larsen, supra.

Contrary to the above decisions, several courts have determined that the Service's lien attaches to post-petition property. In re Crossroads Market, Inc., 190 B.R. 269 (Bankr. N.D. Miss. 1994); In re National Financial Alternatives, Inc., 96 B.R. 844 (Bankr. N.D. Ill. 1989); United States v. Booth Tow Services, Inc., 86-2 U.S.T.C. ¶ 9608 (W.D. Mo. 1986).

Some courts have carved out an exception to the rule that a pre-bankruptcy tax lien does not attach to post-petition assets by allowing the Service's lien to attach to accounts receivable traceable to pre-petition business operations. Id. However, this exception is not sanctioned by section 541 and is inconsistent with the rationale that such property is not owned by the taxpayer-debtor. E.g., In re May Reporting Services, Inc., 115 B.R. 652, 658 (Bankr. D. S.D. 1990); In re Larsen, supra.

A second reason cited for allowing attachment of the lien is B.C. § 552(a), which prohibits post-petition property from being subject to pre-petition consensual liens. Section 552(b) creates an exception which allows consensual liens to attach to the proceeds, product, offspring, rents, or profits earned from pre-petition property if the security agreement underlying the lien extends to such after-acquired property. Because section 552(a) applies only to voluntary, consensual liens, some courts have made the negative inference that statutory liens such as the tax lien under I.R.C. § 6321, which result from the operation of law, attach to post-petition property to the extent they are not voided pursuant to B.C. § 506(d) (lien to the extent it is not an allowed secured claim is void). In re National Financial Alternatives, Inc., supra; United States v. Booth Tow Services, Inc., supra.

Ninth Circuit Law

The Ninth Circuit Court of Appeals has adopted the principle that a pre-bankruptcy tax lien does not attach to assets acquired after bankruptcy. In re Braund, 289 F. Supp. 604 (C.D. Cal. 1968), aff'd sub nom. United States v. McGugin, 423 F.2d 718 (9th Cir. 1970), cert. den., 400 U.S. 823 (1970); In re Carlson, 292 F. Supp. 778 (C.D. Cal. 1968), aff'd, 423 F.2d 714 (9th Cir. 1970); cert. den. sub nom. California State Board of Equalization v. Carlson, 400 U.S. 819 (1970). Although adopted by the Ninth Circuit in 1970 with respect to an issue of statutory interpretation under the Bankruptcy Act, more recent opinions confirm this principle as the law of the Ninth Circuit. See, e.g., In re Fuller, 134 B.R. 945 (9th Cir. BAP 1992); In re Connor, 27 F.3d 365 (9th Cir. 1994).

In Braund, supra, prior to the debtor's bankruptcy, the Service filed liens attaching to life insurance policies belonging to the debtor. The liens secured tax liabilities which were discharged in the bankruptcy. Following the debtor's discharge the Service levied against insurance companies to obtain property acquired since the discharge, i.e., the increase in the cash loan values of the insurance policies. The District Court ruled that the liens did not attach to the after-acquired property and the Ninth Circuit affirmed.

In Carlson, supra, the California State Board of Equalization (the Board) had filed liens securing the debtor's outstanding tax liabilities before he filed a bankruptcy petition. The taxes were dischargeable. After the petition was filed, the Board levied on the salary of the debtor which had been earned after the petition filing. Carlson was decided in the same district court as in Braund (Central District of California), by a different judge who ruled within hours after the oral ruling in Braund was announced. The court in Carlson affirmed the bankruptcy referee's order enjoining the Board from collecting the tax liability, which limited the Board to only a partial payment from the sale and distribution of pre-bankruptcy assets.

On appeal, the Ninth Circuit issued an identical opinion in both cases, affirming the district court. The Court gave its legal analysis and holding in one succinct statement: "There are substantial arguments on both sides, but we have concluded that on balance the result reached in these decisions is the better one."

It is important to note that neither the district court nor the Ninth Circuit made a distinction between (i) the post-petition growth in the cash loan values of the pre-petition life insurance policies (Braund) and the (ii) the debtor's salary earned post-petition (Carlson). This leads to the general conclusion that for purposes of determining the post-petition effect of a tax lien, the

Ninth Circuit treats post-petition appreciation in the value of property to which a lien had attached pre-petition the same as property which came into existence only after the petition was filed.

The present case, in which there was a noticed lien on pre-petition real property to secure taxes discharged in a Chapter 7 proceeding, and post-Chapter 7 appreciation of the real property is in issue in a subsequent Chapter 13 proceeding, would present an issue of first impression in the Ninth Circuit. In Braund, the court did not state whether the post-petition increase in the cash loan values of the life insurance policies resulted from premium payments made by the debtor from funds earned post-petition. By contrast, in the present case it is reasonable to assume that at least some portion of the post-Chapter 7 appreciation of the subject real property is due to nothing more than general market conditions which occurred post-petition. In this situation, one could argue the long-standing principle "that liens on real property pass through bankruptcy unaffected" (Dewsnup v. Timm, 502 U.S. 410, 112 S. Ct. 773, 116 L. Ed.2d 903 (1992)) applies to the lien in the present case, allowing the Service's surviving lien against the debtor's pre-petition real property to attach to the full fair market value of the property at the time the Service makes its claim for payment.

While we recommend the Service take this position, it should be recognized that existing Ninth Circuit precedent (Braund, Carlson and Fuller, supra) represents a hazard that the Service's lien would be held to attach only to the value of the real property measured at some point during the Chapter 7 proceeding, such as the petition filing date or the date of discharge.

CONCLUSION

In light of the above, we recommend that the Service take the position that the secured claim in the Chapter 13 proceeding is to be valued using the current fair market value of the real property at the time the Service submits a "claim" to a portion of the proceeds from the sale or refinance of the property. It should be recognized that such a position is subject to hazards should this issue be litigated.

If you have any questions, please contact the undersigned at (415) 744-9228.

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